DEPARTMENT OF STATE REVENUE

02-20120296.LOF

Letter of Findings Number: 02-20120296
Income Tax
For Tax Years 2009 & 2010

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ISSUES

I. Income Tax–Royalty Income.

Authority: IC § 6-8.1-5-1; IC § 6-3-2-20.

Taxpayer protests the Department's proposed assessment as it relates to royalty income.

II. Income Tax–Foreign Gross Up.

Authority: IC § 6-3-1-3.5.

Taxpayer protests the Department's proposed assessment as it relates to foreign dividends.

III. Tax Administration–Penalty and Interest.

Authority: IC § 6-8.1-10-2.1; IC § 6-8.1-5-1; 45 IAC 15-11-2.

Taxpayer protests the imposition of penalty and interest.

STATEMENT OF FACTS

Taxpayer filed a 2010 Indiana corporate income tax return. The Indiana Department of Revenue ("Department") disallowed two deductions–royalty income and foreign dividends. Taxpayer filed a protest, and a telephone hearing was subsequently held. Further facts will be supplied as required below.

I. Income Tax–Royalty Income.

DISCUSSION

The Department notes at the outset that under IC § 6-8.1-5-1(c) the Department's proposed assessments are presumed to be correct.

Taxpayer's protest letter states that it is protesting "the amount of tax, penalty and interest assessed to [Taxpayer] in the amount of $13,829.82 for tax year 2010...." (Note: at other times Taxpayer references other tax years; as will be seen below, 2009 and 2010 are the years impacted). The two issues are royalty income and foreign dividends. Regarding the former, Taxpayer states that it holds intangibles for affiliate stores. Taxpayer states that the royalties are charged at an arm's length price. In its protest letter, Taxpayer states:

> The first issue is the handling of the intangible expenses. Each year [Taxpayer] received royalty income from its subsidiaries and affiliates for certain intangibles that [Taxpayer] licenses. Several [Taxpayer] affiliates file an Indiana Corporate Tax Return and as a result needs [sic] to add back to income any royalty expense paid to [Taxpayer] as per Indiana Code §6-3-1-3.5(b)(9) and §6-3-2-20(b). Therefore, the affiliates are paying tax on the disallowed royalty expense. Conversely, [Taxpayer] should not pay tax a second time on the royalty income received from the affiliates, and therefore the royalty income should be excluded from [Taxpayer's] income.

In other words, Taxpayer is asserting that the intangible income has already been subjected to tax on its affiliate's returns. Taxpayer asserts this, but did not establish that its affiliates had in fact been subjected to Indiana corporate income tax, or had added back royalty expenses.

Despite Taxpayer's protest, there is not an Indiana statutory mechanism available for Taxpayer (the recipient) to deduct the royalty income. The relevant statute IC § 6-3-2-20, states in part:

> (c) The addition of intangible expenses or any directly related intangible interest expenses otherwise required in a taxable year under subsection (b) is not required if one (1) or more of the following apply to the taxable year:
>
> (1) The taxpayer and the recipient are both included in the same consolidated tax return filed under IC 6-3-4-14 or in the same combined return filed under IC 6-32-2(q) for the taxable year.
>
> (2) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:
>
> (A) the item of income corresponding to the intangible expenses and any directly related intangible interest expenses was included within the recipient's income that is subject to tax in:
>
> (i) a state or possession of the United States; or
>
> (ii) a country other than the United States; that is the recipient's commercial domicile and that imposes a net income tax, a franchise tax measured, in whole or in part, by net income, or a value added tax;
>
> (B) the transaction giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient was made at a commercially reasonable rate and at terms comparable to an arm's length transaction; and
>
> (C) the transactions giving rise to the intangible expenses and any directly related intangible interest

expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(3) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient regularly engages in transactions involving intangible property with one (1) or more unrelated parties on terms substantially similar to those of the subject transaction; and

(B) the transaction giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(4) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the payment was received from a person or entity that is an unrelated party, and on behalf of that unrelated party, paid that amount to the recipient in an arm's length transaction; and

(B) the transaction giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(5) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient paid, accrued, or incurred a liability to an unrelated party during the taxable year for an equal or greater amount that was directly for, related to, or in connection with the same intangible property giving rise to the intangible expenses; and

(B) the transactions giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose.

(6) The taxpayer makes a disclosure and, at the request of the department, can establish by a preponderance of the evidence that:

(A) the recipient is engaged in:

(i) substantial business activities from the acquisition, use, licensing, maintenance, management, ownership, sale, exchange, or any other disposition of intangible property; or

(ii) other substantial business activities separate and apart from the business activities described in item (i);

as evidenced by the maintenance of a permanent office space and an adequate number of full-time, experienced employees;

(B) the transactions giving rise to the intangible expenses and any directly related intangible interest expenses between the taxpayer and the recipient did not have Indiana tax avoidance as a principal purpose; and

(C) the transactions were made at a commercially reasonable rate and at terms comparable to an arm's length transaction.

(7) The taxpayer and the department agree, in writing, to the application or use of an alternative method of allocation or apportionment under section 2(l) or 2(m) of this chapter.

(8) Upon request by the taxpayer, the department determines that the adjustment otherwise required by this section is unreasonable.

None of the options outlined in IC § 6-3-2-20(c) are applicable to Taxpayer's facts. Additionally, the Department notes, Taxpayer bears the burden of proof under IC § 6-8.1-5-1(c). Taxpayer has not met its burden regarding it taking the deduction. However, it appears the Department not only disallowed the deduction, but added an amount equal to the claimed deduction to Taxpayer's income. Taxpayer should have had no deduction and no addback (Taxpayer did not incur any royalty expenses subject to IC § 6-3-2-20, thus the proper amount of the addback is zero). This appears to have impacted 2009 and 2010, and should be corrected by the Department.

FINDING

Taxpayer's protest of the disallowed deduction is respectfully denied. However, to the extent that the Department added an amount equal to the claimed deduction to Taxpayer's income for 2009 and 2010, Taxpayer is sustained. Taxpayer should have had no deduction and no addback. The Audit Division is requested to review the matter.

II. Income Tax–Foreign Gross Up.

DISCUSSION

Taxpayer also protests "the treatment of the foreign gross up." Taxpayer's protest letter states:

Each year [Taxpayer] receives a dividend from its foreign subsidiary in the [...]. A deemed dividend calculated per Section 78 of the Internal Revenue Code is included in [Taxpayer's] income for Federal income tax purposes for the amount of foreign tax credits associated with the dividend. Indiana Code §6-3-1-3.5(b)(4) allows for the exclusion of Federal Section 78 income in the calculation of Indiana taxable income. [Taxpayer] reported this subtraction as a negative modification on Form IT-20. Indiana's computer system also

disallowed this subtraction modification.

At the hearing, Taxpayer reiterated that Indiana's computer system would not recognize the modification.

IC § 6-3-1-3.5(b) states in part:

(b) In the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:

(1) Subtract income that is exempt from taxation under this article by the Constitution and statutes of the United States.

(2) Add an amount equal to any deduction or deductions allowed or allowable pursuant to Section 170 of the Internal Revenue Code.

(3) Add an amount equal to any deduction or deductions allowed or allowable pursuant to Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States.

(4) Subtract an amount equal to the amount included in the corporation's taxable income under Section 78 of the Internal Revenue Code. (Emphasis added).

Given Taxpayer's assertion that the Department's computer system caused the disallowance, the Department's Audit Division is requested to review Taxpayer's adjustment as it relates to Section 78 and the Indiana code, and to make any appropriate adjustments.

FINDING

Taxpayer's protest regarding the foreign gross up issue is sustained subject to review by the Audit Division.

III. Tax Administration–Penalty and Interest.

DISCUSSION

Taxpayer protests the imposition of penalty and interest. Regarding Taxpayer's protest of the interest, the Department is barred by statute from waiving interest under IC § 6-8.1-10-1(e).

Turning to Taxpayer's protest of the penalty, the Department notes that penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC § 6-8.1-10-2.1. The Indiana Administrative Code, 45 IAC 15-11-2 further provides in relevant part:

(b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

(c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer's protest letter does not develop the penalty issue, and at the hearing Taxpayer asserted that it took measures that it believed were correct and in good faith. As previously noted, under IC § 6-8.1-5-1(c), Taxpayer bears the burden of proof. Taxpayer has not met its burden regarding the penalty and interest issue.

FINDING

Taxpayer's protest of the penalty and interest is denied.

SUMMARY

Taxpayer's protest of the disallowed deduction is denied. However, to the extent that the Department added an amount equal to the claimed deduction to Taxpayer's income for 2009 and 2010, Taxpayer is sustained. Taxpayer should have had no deduction and no addback. The Audit Division is requested to review the matter. Taxpayer's protest regarding foreign dividends is sustained subject to review by the Audit Division. Taxpayer's protest of the penalty and interest is denied.

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